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The length and severity of depressions depend partly on the magnitude of the real and financial mal-adjustment which developed during the preceding boom and partly on aggravating monetary and credit factors - the scramble for liquidity by financial institutions as well as by others, destruction of bank money by bank failures, and similar events on the international level.

Gottfried Haberler, *Prosperity and Depression*
George Allen & Unwin Ltd, London, 1937

Inflation - Deflation?

Compared to the economic and financial throes that prevailed a year ago, the global situation has dramatically improved. As former gloom has turned into high-riding expectations of accelerating global economic growth, the specter of deflation has dropped back into the pages of the history book. Policymakers and economists are fretting once again over that more familiar threat of the past - inflation.

Without question, the booming U.S. stock market, the strong dollar and the ballooning U.S. imports - rising by about $100 billion against a year ago - have played a key role in stabilizing the world economy. But more and more people are wondering how much damage this has done to the stability of the U.S. economy, its financial system and its currency.

Essentially, the new escalation of U.S. credit and spending excesses has precipitated the bursting of the U.S. asset bubble. In particular, the dollar's poor fundamentals have come back to the forefront. The main risk for the U.S. economy, in the consensus view, is that it could overheat, requiring further rises in interest rates. The far greater threat, lurking in the background, is the bursting of the U.S. bubble - with savage deflationary consequences for the world.

In this letter, we continue to explore the excesses and imbalances that in the past three or four years have accumulated in the U.S. economy. In the same vein, we take a critical look at recent plunges in stock prices and implications. True, the U.S. economy has so far proved much more resilient than we could imagine. But the signs of approaching trouble are multiplying in the U.S. financial markets as well as in the currency market. Soon, all eyes will be on America as the greatest threat to the world economy.

CORRECTION OR *THE* CRASH?

The Bear Market for U.S. stocks has arrived with a vengeance. While the major stock indexes, due to a few big, strong stocks, continued to simulate bullishness in the past few months, the great majority of stocks have been slowly but relentlessly grinding down. Actually, the advance-decline ratio already topped out in early April last year.

To give a brief description: The Dow Transports have plunged almost 25% from their May highs and are now down 10% year-to-date. The Morgan Stanley Cyclical index is 20% below its highs and the Dow Utilities 14%. Importantly, the key bull market bellwether financial sector has joined the bear market action. NASDAQ Financials and the S&P Bank index are down 22% and 23% from their April highs. Compared to a year ago, these two indices have lost 12% and 13%. The New York Stock Exchange Financial index has shedded 7% for the year. Moreover, the S&P 500 has declined 10% from July's record highs.

But as more and more stocks and groups are being trashed, the technology sector has, at least until recently,

excelled. Obviously, though, this has more to do with market dynamics than with company and industry fundamentals. With financial and technology stocks having jointly led the bull market for some time, the faltering financial sector has apparently been driving money into the technology sector.

Most likely, derivatives and short covering of late have also played an important role behind this shift. The Morgan Stanley High Tech index, comprised of 35 leading technology companies, has a 1999 gain of 40% and has more than doubled during the past 52 weeks. The tech-heavy NASDAQ 100, having traded at a record level as late as Sept. 20, has a year-to-date gain of about 30% and a 52-week gain of 73%, while the respective gains of the NASDAQ Telecommunications are 25% and 67%.

The unequivocal star performers so far this year are semiconductors and Internet stocks. Semiconductors are up 60% in 1999 and almost 130% against a year ago. For the Street.com Internet index, the gains are 50% this year and 200% against a year ago. Interestingly, this index has soared about 40% from its August lows, grossly outperforming the whole market. As the bluechip averages have come under increasing downward pressure, the momentum players have centered their buying on this small sector. With this in mind, we don't see this new run into the technology sector as a sign of a healthy marketplace.

As an aside, the recent sharp tech decline is largely blamed on comments from Microsoft President Steve Ballmer. Speaking of absurdly overvalued stocks, he also used the "gold rush mentality" analogy used by Bill Gates in his book, Road Ahead. According to Bill Gates, "Gold rushes tend to encourage impetuous investments. A few will pay off, but when the frenzy is behind us, we will look back incredulously at the wreckage of failed ventures and wonder,' Who funded those companies? What was going on in their minds? Was that just mania at work?" While pundits were perplexed as to why Ballmer would make such comments, we suggest that with the incredible increase in stock option values, particularly during last year's wild speculative run, technology executives must essentially worry that many key employees will simply take their stock option gains and retire.

Besides the gross overvaluation of stocks, we see significant business risks developing for the technology industry. As the Y2K spending spree is likely to have nearly run its course, the prevailing bullish growth extrapolations for the sector are sure to be disappointed. Undoubtedly, the unprecedented spending spree both by consumers and businesses on computers and peripherals has also been fed considerably by the financial bubble.

With financial stocks faltering and the overwhelming majority of stocks now in an accelerating downtrend, the technology sector is the last pocket of strength in the market, sustaining action and spirits. Not for long, we think. We tend to consider it a last, classic speculative "blowoff." A general sharp decline in tech stocks would be a death blow to the greater U.S. stock market bubble.

WHAT, EXACTLY, IS INFLATION?

For the new paradigm apostles, the concurrence of strong economic growth with falling inflation is compelling testimony of a new era. What, exactly, is *inflation?* Actually, there is a great divide in the usage of the word which, unfortunately, tends to confuse the issue. For most people and economists today, it begins and ends with a sustained rise in the price indexes for goods and services. No more, no less. Evidently, this is to focus on the one most regular symptom of inflation that is most familiar to people and of which they are also most fearful.

Yet despite this widespread focus on consumer and producer prices as the crucial measure of inflation, it has always been conventional wisdom among economists of all schools of thought that inflation is essentially *caused* by excessive money or credit growth. Just think of Mr. Friedman and the monetarists who have for decades been emphasizing this close relationship between money and prices and their consequential categorical

demand that central banks should therefore strictly fixate on controlling money growth as a preemptive measure to prevent inflation before it can develop.

But America is presently facing a situation not foreseen in the conventional textbooks. While money and credit supply are expanding at record pace, the inflation rate has been falling. Measured by the two monetary aggregates, America is in the worst inflation of all times. In fact, the economy is booming. Yet the price level, as measured by the price indexes, appears immune. For many, including Mr. Greenspan apparently, the only explanation they can think of for this blatant incongruity is a new paradigm economy, creating miracles.

Not for the first time, a booming bubble economy is being mistaken for a new paradigm economy. This is actually the rule in history, for an obvious reason: the fallacy to equate inflation exclusively with one single effect: a significant rise in consumer and producer prices. If this specific effect is missing, it means for most people the absence of any inflation.

Although it may at first blush appear highly paradoxical, asset price bubbles have regularly happened in periods of falling or low inflation rates in consumer and producer prices. In the 1920s, America had a booming economy for seven years with zero inflation. On second thought, however, this coincidence is anything but paradoxical. Low rates of inflation are, actually, the indispensable condition that regularly misleads central banks to their ill-guided stance of prolonged, excessive monetary looseness. Their manifest, cardinal mistake regularly lies in the narrow focus on the conventional price indexes as their one and only measure of inflation.

While defining and measuring inflation, the first important point to recognize is that its essence is not in the price indexes but in the fact that a financial system is allowed to create credit in excess of savings. The second important point to realize is that the pattern of inflationary effects arising from credit excesses may vary considerably, depending on who the main borrowers are - government, consumers, businesses or investors - and on what the inflated credit flow is spent. In the present U.S. case, by far the greater part of the runaway credit creation has been going into purchases of financial assets - outside the gross national product - and furthermore into ballooning goods *imports* which over the last four years have soared by 80% to $1.2 trillion, and this moreover at falling prices.

This deluge of goods imports is, in itself, the best explanation of the lack of pricing power in the United States, defying the immense credit excesses and the booming domestic demand. But for this to happen, it needed a congenial international environment: foreign countries with substantial excess capacity to match the runaway U.S. domestic demand. The whole rest of the world, Europe, Japan, Southeast Asia, possesses plenty of that. In addition, collapsing currencies in Southeast Asia translated into substantially lower U.S. import prices.

Considering all these influences, it is obvious that consumer and producer prices essentially failed to reflect the actually existing inflationary pressures in the U.S. economy. In the 1970s, the excess credit went overwhelmingly into rising demand for goods, services and tangible assets, boosting their prices. This time, the brunt of inflation is in the booming asset markets and the mushrooming trade deficit. Also, some other forces may be keeping a lid on price inflation. In the 1920s, by the way, it was exceptionally high productivity gains from the Industrial Revolution.

KEYNES ASKED AMERICAN ECONOMISTS

This is not for the first time that we have addressed this question about the essence and pattern of inflation. In this regard, we have occasionally referred to an incidence in the late 1920s, involving Keynes, which strikingly illustrates the differences in approach. It started within the board of the National Mutual Assurance Company, of which Keynes was Chairman. One member of this board, Mr. Falk, recommended that the company should dispose of the bulk of its American securities "because there was serious inflation in America

and that the Fed would have to deal with the situation through monetary tightening. If the Fed did not so act, he believed that there would be a reaction from current stock price levels which might be severe."

Keynes rigorously disagreed. In the course of the following discussions, he wrote and circulated two papers to several economists, bankers and officials in America. What he wrote actually revealed highly muddled thinking both about inflation and money and credit creation. Here some brief excerpts:

Inflation - put broadly - means that, for some reason or another, the stream of consumers' buying is increasing faster than the stream of finished goods available to them to buy, *with the result that prices rise.* It is not convenient to mean by it anything else. But we might give the name latent or potential inflation to a situation which is likely to lead to actual inflation if it is allowed to develop unchecked...

At the time, however, Keynes met with strong disagreement from his American counterparts, both inside and outside the Fed. One of them, Mr. Burgess, answered in the name of Governor Strong of the Federal Reserve New York:

> "He [Mr. Strong] discussed it [your letter] with me yesterday and asked me to tell you that he had read the memorandum with the greatest care but has found in it so many points where he believes either your facts or your conclusions are wrong that, with his limited strength, it would be too much of a task to attempt to reply. ...I do not think we have had a serious inflation in this country but I do think we have been in grave danger of it and have some inflation in particular directions, all of which depends on the definition for inflation, and they are seldom obvious until after the event.

Emphasizing his full agreement with it, Mr. Burgess attached a more comprehensive memo to his letter, specially written for Keynes by another Fed member, C. Snyder. Here a brief excerpt:

> Owing to the abundance of credit, in excess even of what appears to be about the maximum possible growth of trade, there came a heavy expansion of bank investment...This buying of bonds, of course, gave a tremendous fillip to the stock market, and there ensued a corresponding expansion of speculative loans... These security loans have had an enormous expansion in recent years, accompanying the greatest rise in stock prices which this market has ever seen.

All this has been accompanied...by what appears to be...the greatest building boom which this country has known in 60 years. Of course we may have entered the millenium; but this is always difficult to be sure of, and what we know is that a large part of this tremendous building has been purely speculative...

Of course, all this is new to our economists; they do not understand it and they cannot believe it. But I think that in another ten or 20 years it will be different.

Another interesting answer came from Mr. C.J. Bullock, president of the Harvard Economic Society:

> You simplify things greatly by assuming that the seller of the stocks invests the proceeds in a time deposit and then sits down on the side lines and doesn't speculate anymore because he thinks the stock market is too high...
>
> ...The thing that impresses us is not so much the expansion that has taken place, but the insistent call for more and more credit which results from the speculative mania produced by the previous expansion...
>
> You say, correctly enough in principle, that, if there has been overexpansion, that would show itself in the prices of commodities, of which there is so far no evidence. More recent price movements give a somewhat different picture...It is beginning to look as if the inflation of credit was affecting commodity prices...Personally, I shall be surprised if these movements go very far this year...Most of the

commodities in question are international commodities; and I doubt if, even if credit continues to expand here, its rate of increase will be enough to affect international markets greatly and produce anything to be called inflation.

Even so, we should not conclude that credit hasn't been inflated, or that other things, like stock prices and real estate, haven't been inflated. Since 1922 we have had peculiar conditions in the United States which have brought about a vast expansion of credit, which, for one reason or another, just hasn't affected commodity prices...

Nothing in the etymology or history of the word inflation justifies us in limiting it to commodity price inflation. When I say this, I hasten to add that for the student of the business cycle commodity price inflation has peculiar importance; but I am not ready to say that it is the only kind of inflation that is significant.

TWO DIAMETRICALLY DIFFERENT FEDS

Now, please compare these thoughtful remarks about the essence and nature of inflation, written by American officials and economists in 1928 with today's simplistic palaver about the new paradigm economy and the associated roaring stock market boom. What's more, the U.S. economy's performance in the 1920s vastly surpassed that in recent years.

To begin with, America was the world's leading creditor country with a chronic current-account surplus accruing from a domestic savings surplus. Annual real GDP growth averaged a little more than 4% between 1923-1929; yet consumer prices in 1929 were no higher than in 1923, while wholesale prices had fallen at an annual rate of 1%. At the root of this stellar economic performance was a 70% productivity growth per man-hour in manufacturing between 1919 and 1929, implemented by the industrial technological revolution and an associated boom in business capital spending. Labor costs fell steadily as wages failed to rise as rapidly as productivity.

Drawing a comparison between the two periods, there is still another striking difference to be mentioned. It concerns the posture of Federal Reserve Chairman Alan Greenspan and that of his colleagues in the 1920s towards the unfolding stock market bubble. Mr. Greenspan himself, without any question, has been a conspicuous bull leader in words and deeds. In all of his now frequent speeches, he has deliberately fostered Wall Street's New Era myth by extolling the alleged high tech miracle that lies behind the U.S. economy's strong growth and low inflation. Events have now progressed to the point where more and more observers are openly talking about "Greenspan's bubble." His behavior contrasts diametrically with that of the Federal Reserve in the late 1920s.

In 1928/29, the Federal Reserve had watched the booming stock market with growing fright and horror. Regarding it as a dangerous development, it tried to stop it with rate hikes, but it was unwilling to hit the brakes strongly enough for fear of weakening the economy. While President Coolidge and Treasury Secretary Mellon did encourage the rise in stock prices with many favorable declarations, the Fed made no secret of the fact that it was afraid of the boom. No Fed member ever give a hint that the Industrial Revolution and its high productivity gains were allowing easier money and justifying the roaring boom in stock prices.

Today it is accepted wisdom that the Fed made its crucial mistake in August 1927 in the wake of a secret conference among the governors of the four leading central banks in the world. Governor Norman of the Bank of England and Governor Strong of the Federal Reserve New York pleaded for a joint monetary easing in order to help the ailing British economy and currency. Both the German, Hjalmar Schacht, and the Frenchman, Charles Rist, flatly refused. After the two had left, Strong and Norman forced through their program of cheap money in the United States. A rather supine Federal Reserve Board immediately obliged with a cut of the discount rate to 3.5% and large liquidity injections into the banking system through security purchases.

After having languished since late 1925, stock prices soon began to zoom. Alarmed by this violent reaction, the Federal Reserve in New York raised its rate successively to 4% in February to 4.5% in May and to 5% in July 1928. In lockstep, it squeezed bank reserves with heavy sales of government bonds with the effect that the call rate on stock exchange loans shot up - hovering over 10% at the end of the year. All to no avail. A highly resistant boom atmosphere and speculative frenzy had seized the stock market. Between mid-1927 and September 1929, the Standard & Poor Stock Index shot up by about 90%.

Price earnings for industrial stocks actually peaked in January 1929 at 16.2, compared with a traditional 10:1. Today the S&P 500, P/E ratio is presently at 35 with a dividend yield of 1.25%, the S&P Industrial Index is at 42 times earnings with a dividend yield of 1.07%. Clearly, valuations today exceed those of the late 1920s to an absurd extent.

DEFINING "CREDIT INFLATION"

But back to our central question: How does one define and measure "inflation"? Hopefully, we have convincingly explained that the custom of looking solely at the price indexes is much too narrow an approach. Credit excesses can flow in many different directions and consequently impart very different effects on the warp and woof of an economy, other than rises in consumer and producer prices. Essentially, the narrow focus on the price indexes has regularly misled central banks to prolonged, excessive monetary looseness.

On the surface, the U.S. economy of the 1920s seemed to be bursting with health and strength, just like the Japanese economy in the late 1980s. But how did they all of a sudden turn into houses of cards? To this question, only Austrian theory gives a straightforward answer: Both economies and their financial systems were savagely unbalanced by a prolonged oversupply of credit that had fueled unsustainable speculative excesses in the markets on the one hand, and massive, unsustainable distortions and maladjustments in the economy on the other.

Over time, the two economies became dangerously dependent upon the perpetuation of their asset bubble. When the bubbles burst, 1929 in America and 1990 in Japan, the credit creation mechanism broke down, and the economies descended into a long and devastating slump. It is, after all, three interacting conditions that tend to lead later to deflation and depression, once the bubble bursts: first, the collapse of the inflated asset prices, second, a very frail and vulnerable credit system, and, third, unsustainable spending excesses in the economy.

As we have repeatedly pointed out, Mr. Greenspan has presided over the creation of the biggest credit bubble in history. Yet in his numerous speeches and congressional testimonies, he never mentions credit. After a recent testimony, Representative Mark Stanford, South Carolina, asked him: "Are we going to live happily ever after, or are we indeed on the edge of something? In other words, are we in fact in a new era, or is this an asset bubble?"

He got the following hocuspocus from Mr. Greenspan:

"Strangely, it's possible for both conditions to exist simultaneously. The one thing I am reasonably certain of is the synergies of technologies that have evolved basically out of the integrated circuits, microprocessors, then combination of lasers and fiberglass optic - the whole telecommunications synergy structure - it's interesting that until fiberoptics came along, lasers did not, were not perceived to be a particularly crucial issue. They have turned out to be phenomenal."

Apparently, Mr. Greenspan has yet to realize that the credit deluge he has unleashed is his crucial issue. Basic to the process of *inflation* is credit creation in excess of current savings. By definition, this ranks as "credit inflation". Its essence is that it inflates the purchasing power flowing into the economy and the asset markets. As to new saving, its essence is that it releases resources to match the spending of the borrowers. Hence the

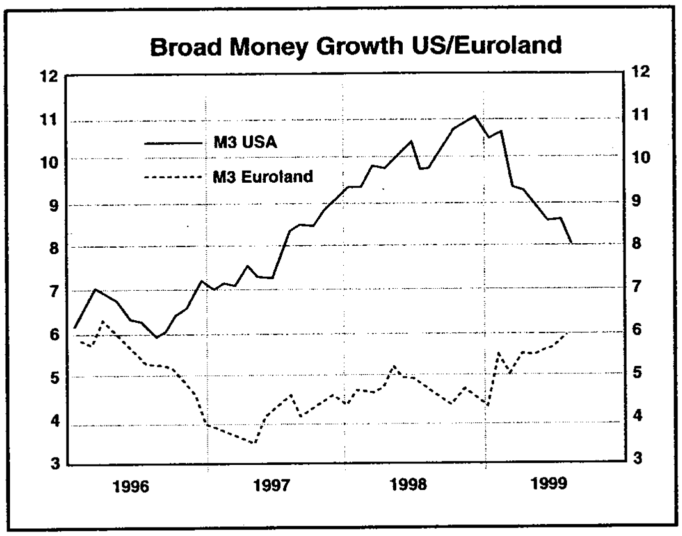
postulate of the classic economists that non-inflationary credit is limited by available savings. As capital gains in the stock market, plainly, don't meet this requirement of releasing resources, they cannot be equated with savings. All this used to elementary knowledge in economics – at least in Europe.

Last year, the U.S. credit machine generated more than $2 trillion of new credit. This compared with negative personal savings and nominal GDP growth of $400 billion. For every dollar added to GDP, there were five dollars added to debt. In the late 1920s, by the way, this debt ratio was 2:1, and between 1950-80, it has averaged 1.35:1. Manifestly, this is the most rampant credit inflation in history.

CREDIT VERSUS MONEY

To reiterate: *Credit inflation* - meaning credit expansion in excess of available savings - implies a corresponding net addition to purchasing power through credit creation. However, the U.S. money supply has grown much slower than the credit supply. M2 rose $356 billion last year, while M3 rose $595 billion. Still, this was the most rapid money growth in the whole decade. M3 grew 11%, after 9.1% in 1997 and 7.3% in 1996.

Which of the two aggregates - credit or money - gives the best measure of underlying creation of purchasing power? Our categorical answer: credit. This applies particularly to America where borrowing and lending in the past several years has massively shifted to credit channels outside of the banking system where, in contrast to bank lending, it involves no money creation. In the United States, actually, the main sources of credit creation today are the securities markets and a plethora of non-bank financial intermediaries. With investment bankers and non-bank financial intermediaries now the kings of credit creation in the United States, the money supply data are a woefully inadequate indicator of monetary conditions. But whence do the floods of money come that these institutions deploy?



In short, from the *existing* money stock in the United States, presently amounting to more than $6 trillion. A common underlying feature of this rampant credit creation outside of the banking system is the circumstance that owners of low-yielding existing money balances try to increase their return by purchasing, often with heavy leverage, all kinds of debt instruments offered in the securities and the money markets by corporations and such non-bank lending institutions, among the most aggressive of them are our special friends, Fannie Mae and Freddie Mac. After beginning the decade with assets of about $150 billion, they are now rapidly approaching total assets of $1 trillion.

What effectively happens is that existing bank deposits are transferred to these intermediaries which, in turn, use these deposits to finance the acquisition of mortgages and asset-backed securities. This is significant from the monetary point of view because such lending leaves the existing money stock unchanged. In the last analysis, these credit flows are financed by more intensive utilization of the *existing* money stock. Rather than increasing the money supply, the credit and debt creation both through the capital markets and these non-bank intermediaries increases money velocity in the way that existing idle bank deposits are activated for spending by the ultimate borrowers.

More than anything else, it is the borrowing-and-lending explosion of these most aggressive non-bank

financial intermediaries that has made the American credit machine virtually indomitable in the last several years. There is nothing like it in other countries. And this has a reason: While the proliferation of new credit channels in America is hailed as a great achievement of the financial system, the authorities in most other countries regard the development of such financial intermediaries as strictly undesirable because it essentially tends to make credit creation uncontrollable.

THE GREAT DEBATE

Economists and investors of the world are presently divided into two camps. Putting it into two oversimplifying buzzwords, it's *inflationists* versus *deflationists.*

Bond markets worldwide have become jittery about the possibility of a V-shaped recovery of the global economy, led by an overheating U.S. economy. The main contention of the inflationsts is that the massive monetary easing in the wake of the Asian and Russian crisis has imparted excessive impulses to the global economy. More than 140 rate cuts were counted. The prime effect was spectacular rises in stock markets. But lately, economic news from most parts of the world is surprising to the upside, leading many to the conclusion that this convergence of global demand growth will bring back inflation, forcing the Fed and other central banks to raise their interest rates.

In the view of the deflationists, a word that we use with great reservations, the world economy is in such rotten shape that a sustained, global recovery of sufficient strength to reignite significant price inflation is a virtual impossibility. Yes, the massive monetary easing late last year had tremendous stimulatory effects - on stock markets and expectations. But as to the effects of the Great Global Reflation on the economies, the jury is still out, putting it very mildly.

In its recently published annual Global Development Finance report, the World Bank disclosed that it had lowered its forecast for economic growth in the developing countries to 1.5% this year from the 2.7% it had predicted last October. This is their slowest growth rate since 1982. The report mentions three chief causes for this deterioration: weak world trade growth, falling commodity prices and a lack of external finance. The fact is that publicity tends to concentrate on the countries that are doing well after the drastic devaluation of their currency.

What about Japan's predicted economic recovery which the Tokyo stock market has been celebrating for months? Compare the following brief excerpt from the latest monthly report of the Bank of Japan with the bullish reports about Japan in the media and from brokers.

"Japan's economy, at present, has stopped deteriorating, and corporate sentiment has seen a slight improvement. However, clear signs of a self-sustained recovery in private demand have not been observed yet.

With regard to final demand, business fixed investment has been on a downward trend. Recovery in private consumption continues to be weak on the whole. Net exports (exports minus imports) are sluggish at present due to an increase in imports... Meanwhile housing investment has continued to recover, and public works have been rising.

The improvement in corporate sentiment, however, has not necessarily stimulated business activities because firms strongly feel that they have excess capacity and employees and their profits remain weak. Meanwhile, the improvement in consumer sentiment is underpinning household expenditure even under the worsening employment and income conditions, but it is not strong enough to push up overall private consumption."

What patently fueled the sudden optimism about Japan's economy was the fact that, mainly government-fueled economic growth in the first two quarters of this year exceeded very modest expectations. As usual, this was readily extrapolated as the new established trend. On closer look, however, it is obvious that in Japan's case

the key essentials for a self-sustaining and self-accelerating expansion continue to be completely missing. Profits are still falling and credit is barely flat before big deductions of bad loans. No less importantly, actual growth lags increasingly behind potential growth, resulting in a soaring output gap.

As for Euroland, the economic prospects are incomparably better than for Japan, although it had become the pattern to focus on Germany and Italy as the weakest links. Overall, there has nevertheless been a steady acceleration in real GDP growth from 1.3% (1996) to 2.3% (1997) and to 2.8% (1998). Still, recent better-than-expected economic data promptly contributed to the inflation jitters in the bond markets.

Yet there is not the slightest chance for any inflationary growth in Euroland. Irrespective of the booming, peripheral countries, economic growth in the area as a whole, being determined by Germany, Italy and France, has settled down to a moderate long-term trend of around 2% annually, which is well in line with potential growth. With an eye on the many spending and lending excesses propelling U.S. economic growth, we ascribe the economic temperance in Euroland chiefly to two influences which are basically structural: first, absence and improbability of consumer borrowing excesses, and, second, subdued cycles both in business and residential investment. There is still a lot of old-fashioned financial conservatism in Europe, thank goodness.

A resurgence of economic growth in Europe and Asia on top of strong growth in the United States ending the period of low inflation rates has become the great fear of investors in the global bond markets. Ironically, the very same perception is the great hope of investors in the stock markets. In their view, the rise in foreign demand will boost U.S. exports and corporate profits while stabilizing the dollar by curtailing the monstrous U.S. current-account deficit. To quote Business Week: "A smart bet would be that the rebalancing going on in the world economy will prove beneficial to U.S. growth - and U.S. equity markets." Happy End.

With the U.S. current-account deficit on track to exceed $300 billion this year, we are sure that this Happy End will not materialize. Within just two years, this deficit has more then doubled. Remarkably, this has occurred overwhelmingly through soaring U.S. imports, despite a strong export performance and substantial terms-of-trade gains. Essentially, the import deluge reflects two things: the credit-fueled domestic spending binge and lacking growth of industrial capacity.

This realization leads us to the chief reason of our disbelief in the described Happy End for the U.S. economy and a possible global return to higher inflation rates. To achieve these two effects, it needs more than just demand growth in the rest of the world. It would need demand growth in excess of capacity growth in Japan, in Europe and in the developing countries. But is nobody projecting or even considering that as a possibility. Most probably, demand growth in many countries will continue to fall short of this target.

We have come to the view that the U.S. external deficit in current account has become far too big to be significantly reduced by a feasible increase in foreign demand. In any case, it would require substantially lower U.S. domestic demand growth in the first place to release the resources that are necessary for higher U.S. exports.

Putting it more poignantly: The countries in Europe and Asia are neither able nor willing to accommodate the current, rampant U.S. credit inflation with commensurate inflation on their part. But what is the alternative if the inflationary solution is impossible? In brief, the deflationary solution. It is actually in the nature of bursting financial bubbles that they preclude following inflation.

LOTS OF DANGER SPOTS

There is a widespread, comforting belief in the markets that the booming U.S. economy as well as the booming stock market are perfectly safe if only the Fed avoids serious tightening which, of course, is taken for granted. And for sure, Mr. Greenspan cherishes the idea of being the first central banker in history who will succeed in finessing such a bubble to a soft landing.

In his many public speeches, Mr. Greenspan has time and again stressed the important role of the stock market boom in fueling strong consumer and business spending. By definition, this is the essence of a "bubble economy". He is, actually, the first central banker in history who publicly hails this kind of development. On this reading, he is sure to do all he can to keep the bubble budding, simply because the consequences of a mere ceasing are too awful to contemplate. More to the point, he has no option.

Essentially, this raises the question, what else may possibly pop the U.S. bubble if the Fed refuses to do so? Our preliminary short answer is: borrowing and spending excesses essentially becoming unsustainable over time. Not only that. In order to maintain their effect, they have to compound all the time, and that simply is not feasible.

Take the saving collapse in the United States. During recent years, it has financed 32% of the growth in consumer spending. In the 1980s, by the way, this rate was 8%. Can the consumer go on like this? Yes, but not indefinitely. Since 1995, the personal saving rate has plunged from plus 3.5% to minus 1.5% of disposable income. The critical snag, now, is that just to keep up the growth in consumer spending, the rate of dissaving has to accelerate indefinitely - to minus 3% in 2000, to minus 4.5% in 2001 and so on. By contrast, if U.S. consumers merely decide to stop the increase in dissaving, GDP growth will fall year for year by 1.2%. Clearly, this is a vicious trap. Does Mr. Greenspan know? He ought to.

It is not just the private households that are engaged in an unsustainable borrowing and spending binge. Nonfinancial businesses are accumulating debt at an unprecedented rate, but for what? In continuation of the trend that started in the 1980s, the borrowing overwhelmingly serves to leverage corporate balance sheets through acquisitions, mergers and stock repurchases - rather than to put in place new plant.

THE GREAT FRAUD

According to media reports, governmental statisticians are working overtime to "modernize" their measuring rods. Happily, with their improved methods, they are unearthing nothing but considerable improvements, revealing a much healthier and stronger economy. GDP growth, productivity gains, personal savings, business profits, everything important is reported to come out much better than the prevailing statistics had shown.

Mr. Greenspan gave the cue in his speech on Aug. 27 in Jackson Hole, Wyoming. After admitting that reported U.S. corporate earnings are augmented by the widespread use of stock options and the reduction of corporate contributions to pension funds through the rise in stock prices, he ended up by stating that these profit distortions to the upside are, however, more than offset by other distortions to the downside, concluding, U.S. business earnings are understated.

His key argument: "A substantial portion of software spending is expensed, even though the equity prices of the purchasing companies are clearly valuing the software outlays as contributing to earnings over their useful economic lives - the relevant criterion for capitalizing an asset."

His intention to justify the high stock prices is too obvious. But believe find, Mr. Greenspan is comparing apples with pears because there is a decisive difference between the comparative effects on corporate profits. The use of stock options and the omission of corporate contributions to pension funds raise the profit level in a massive and lasting way. As opposed to this, capitalization and following depreciation of software spending only changes the time pattern of profits over a short span of time, considering that the depreciation of this spending, when capitalized, would certainly take place within 2, 3 or at most 4 years. Initially, profits are increased but later decreased. Given the continuous high expenditure of corporations on software, after a slow start depreciation would quickly catch up with current expenditure.

We view with the same incredulity the hectic attempts being made to explain away the relevance of the vanished U.S. savings ratio. Officials will soon announce that new calculations will show it in positive, rather

than negative territory. But the far more important and decisive fact is that the steep downtrend of the personal saving ratio is unsustainable, implying that the associated consumer spending boom is equally unsustainable.

IMPENDING DOLLAR CRISIS

Back to the question: What is the most probable and biggest threat to the U.S. economy and the world economy - inflation or deflation? Without the slightest hesitance, we insist: The looming, biggest threat is not a sudden burst of global spending resulting in price inflation, but a collapse on Wall Street. This American bubble has defied its skeptics not because of a new paradigm but because the Fed, having peered over the precipice to deflation, has decided to support the bubbling financial system at each and every turn rather than to restrain it.

But as Japan strikingly demonstrates, for monetary looseness to stimulate spending, it essentially requires consumers, businesses and a financial system that are willing to take the bait. In America in the past few years, all three have virtually fallen over themselves to comply. But so did the Americans in the late 1920s and so, by the way, did the Japanese in the late 1980s - until their bubbles burst.

With evidence of the developing bear market in U.S. stocks mounting, it certainly is time to reflect on possible or probable economic and financial repercussions for the United States and the world. Could there be a recession in the United States? Perhaps even a Japanese-style recession?

Remember Haberler's quote on the first page: "The severity of depressions depends partly on the magnitude of the maladjustments that have developed during the preceding boom and partly on aggravating monetary factors." On both counts, Mr. Greenspan is in for great trouble. Not only does he have to deal with an extremely unbalanced economy and financial system, but also with the aggravating factor of a currency that has become hostage to the unremitting attractiveness of U.S. financial markets to foreign capital. Oddly, the dollar has been slumping against the yen at a time U.S. interest rates are going up. That is not supposed to happen.

The dollar has regularly gone into prolonged, sharp decline, when the U.S. economy weakened, entailing the prospect of rate reductions. And as a rule, its reaction tends to be pretty violent. A year ago, when the Fed implemented its three 0.25% rate cuts, the dollar plunged vertically by more than 20% against the yen and by about 10% against the European currencies. This observation leads directly to the most critical issue today: What will the Fed do when the U.S. economy, sooner or later, shows signs of slowing down?

The optimistic consensus takes great comfort from the idea that the present low inflation rates afford the Fed plenty of room to slash interest rates if necessary. So if Mr. Greenspan plays his cards right, which his numerous admirers take for granted, the U.S. expansion can continue, albeit with more moderate growth.

It is conveniently overlooked what such Fed easing might do to the dollar. True, "benign neglect" vis-à-vis the currency is traditional U.S. policy. But with a current-account deficit that has nearly trebled since 1995 to currently well over $300 billion annually and a meanwhile rise in foreign indebtedness, the dollar has essentially become vulnerable as never before. More than anything else, the buoyant stock market and the strong dollar are the glaring virility symbols of the "new paradigm" economy. If they crack, it will crack the prevailing glaring perception of the U.S. economy's superior health and strength. In out view, there is definitely the potential for a carnage in the markets.

ON CLOSER LOOK...

Undiminished U.S. economic vigor is the great surprise so far this year. On closer look, though, the pattern of growth is so immensely out of balance that it defies comprehension: In the first half of 1999, consumer borrowing and spending came to 125% and business investment on computers to 75% of real GDP growth. Counterpart to this colossal spending excess was the exploding trade deficit. Almost half the rise in domestic demand was satisfied by foreign producers.

Plainly, consumer spending and business computer investment are now the key propellants of U.S. economic growth. But as recent letters have explained, we look at the high computer numbers - in terms of so-called chained dollars - with great reservation. Consider that during the first half of this year this component added the huge amount of $87.2 billion to real GDP growth. In current dollars, however, it was a paltry $7.3 billion. This is absurd statistics.

If computers are stripped out of the GDP calculation in chained dollars, U.S. real GDP growth during the first half of 1999 shrivels to barely $30 billion or less than 1% at annual rate.

That's a far cry from the perception of an economy that is booming and bursting with strength. Nevertheless, it is effectively a booming economy, but to repeat: it is an extremely unbalanced economic boom. The excesses are clustered in specific areas which, by the way, is the typical pattern of inflation. These overheated areas are, first and foremost, private housing, commercial building, consumer spending and employment. But the point to see is that the attending inflationary symptoms - like rising house prices, a tight labor market and the exploding trade deficit - are not captured in the conventional price indexes.

CONCLUSIONS:

In the United States, rampant inflation is everywhere, except in the price indexes for goods and services. Excess demand is being exported. The U.S. trade deficit soared by nearly $125 billion, annual rate, between December and June.

Again, the Fed softened its paltry rate hike with remarks that is should be sufficient to hold the line on inflation. The favorite explanation for Mr. Greenspan's wariness is anxiety about the vulnerability if the world economy. We think his prime worry is the fragility of the U.S. financial system.

What is really taking place in the U.S. financial markets? Is the broad, sharp rise in market interest rates just a temporary overreaction to inflation fears? Certainly not. We see withdrawal symptoms from the leveraging that went to the most extreme excess in the wake of the Fed's monetary loosening last autumn.

The point to see is that the U.S. financial markets have become addicted to an exponential rise in leveraging. Just like the drug addict who needs ever greater doses of his drug over time to avoid withdrawal pain, the U.S. economy and its financial markets need ever greater doses of leverage to avoid liquidity problems. Credit excess essentially implies diminishing returns.

If U.S. asset prices fail to rise, let alone fall, capital inflows dry up and the dollar plunges, precipitating even outflows over time. The dollar is Mr. Greenspan's Achilles heel.

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Dr. Kurt Richebächer, Editor
Published by The Fleet Street Group
Laura Davis, Group Publisher
Doug Noland, Market Analyst
Aimee Grable, Marketing Manager
Brian Flaherty, Design & Layout

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